FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Berlin Hyp's Long-Term IDR at 'A+'/Negative; VR at 'bbb'

Tue 24 Nov, 2020 - 10:36 AM ET

Fitch Ratings - Frankfurt am Main - 24 Nov 2020: Fitch Ratings has affirmed Berlin Hyp AG's Long-Term Issuer Default Rating (IDR) at 'A+' with a Negative Outlook, and Viability Rating (VR) at 'bbb'. A full list of rating actions is detailed below.

KEY RATING DRIVERS

IDRs, SUPPORT RATING (SR) AND SENIOR NON-PREFERRED (SNP) DEBT RATINGS

Berlin Hyp's IDRs, SR and SNP debt ratings are underpinned by institutional support from the bank's ultimate parent, Sparkassen-Finanzgruppe (Sparkassen, SFG, A+/Negative/F1+), the German savings banks group, which collectively owns Berlin Hyp's immediate parent, Landesbank Berlin Holding AG. In Fitch's view, Berlin Hyp benefits from an extremely high probability of support from the savings banks, if required. Therefore, Berlin Hyp's IDRs are aligned with those of SFG.

The Negative Outlook on Berlin Hyp's Long-Term IDR mirrors that on SFG's Long-Term IDR.

In our view, the savings banks' reputation and their mutual support scheme's credibility would be greatly damaged if SFG failed to support Berlin Hyp, which is part of the scheme, when the need arises. Therefore, we believe that SFG has a very high propensity to support Berlin Hyp. SFG is not a legal entity but a banking network, whose cohesion is ensured by a mutual support scheme. This could increase the complexity of devising extraordinary support measures, but we expect the savings banks to be able to coordinate adequate and timely support measures if needed. Given Berlin Hyp's small size relative to SFG, any required support would be immaterial for SFG.

VR

The affirmation of the VR reflects our view that Berlin Hyp has sufficient headroom at this rating level to absorb significant shocks under our updated assessment of various downside scenarios to our baseline economic forecast. Berlin Hyp's relative resilience amid the outbreak of the COVID-19 pandemic in 9M20 suggests that the bank should be able to retain a financial profile commensurate with its current VR through the crisis.

We expect that Berlin Hyp's profitability (bbb/negative) and asset quality (bbb+/negative) will come under manageable pressure in 2021 and potentially beyond due to the near- and mid-term economic impact of the pandemic. However, we expect the bank's capitalisation to remain commensurate with the current score (bbb+), and have revised the outlook on the score to stable from negative.

Berlin Hyp entered the economic downturn with a low non-performing loan (NPL) ratio of 0.7% at end-1H20, which is stronger than those of most peers and than German banking sector average. This reflects the bank's prudent underwriting standards, including additional caution in international lending. Its NPL ratio has steadily declined over the past decade, underpinned by benign pre-crisis economic conditions in Germany. However, as a specialised lender focused on the cyclical commercial real-estate (CRE) sector, the inherently high concentration of the bank's loan book constrains our assessment of its asset quality. This concentration is partly mitigated by the bank's resilient performance and sound risk appetite. We expect NPL inflows to increase in 2021 when state support measures recede and the effect of the crisis becomes more apparent.

Fitch believes that the attractiveness of the German CRE market for international investors will remain strong despite the acceleration of secular trends (working from home, online shopping) by the COVID-19 crisis. This attractiveness is underpinned by Germany's resilient economy, robust fundamentals and stable institutional framework. The domestic property market has remained relatively resilient and valuations reasonable by international comparison, despite strong price increases over the last decade. Investment yields remain more resilient than in many foreign markets despite a slight decrease in 1H20, driven by low transaction volumes in 2Q20 as deals were postponed or cancelled due to the pandemic.

The retail and hotels segments have been the most impacted by the pandemic so far. If business travel does not rapidly return to pre-pandemic levels, these segments are likely to remain under pressure for longer. We do not expect the strong margin pressure that has weighed for many years on bank financing of German CRE to abate as a result of the current crisis.

Berlin Hyp has maintained adequate levels of profitability in recent years that are commensurate with its risk profile. However, its operating profit peaked in 2018 and started to weaken moderately in 2019, before the outbreak of the pandemic. This is because low interest rates and strong competitive pressure weigh on lending margins, while the bank's revenue mix is dominated by net interest income. Low margins will continue to weigh on performance beyond the coronavirus crisis, because the bank's new business is likely to remain predominantly domestic in the medium term. We expect SFG to ensure that Berlin Hyp will maintain its prudent risk appetite despite the considerable margin pressure that is affecting the German CRE lending market.

We expect earning pressure to further intensify over the next two years as a result of high loan impairment charges (LICs). Berlin Hyp booked LICs of EUR65 million in 9M20 (an annualised 40bp of total loans, up from almost zero on average in 2016-2019) to take into account the anticipated deterioration of asset quality in the near term as a result of the economic fallout from COVID-19. However, credit risks have not yet materialised.

We expect the bank's pre-impairment profit generation to remain a sufficient first line of defence through the crisis. Our base case assumes that Berlin Hyp will maintain a four-year average operating profit/risk-weighted assets (RWAs) of at least 1% through the crisis, in line with its earnings and profitability score of 'bbb'. However, a deeper than expected recession or a slower economic recovery could lead to higher than anticipated credit losses and net annual losses in the next two years.

Berlin Hyp's fully loaded common equity Tier 1 (CET1) reached 12.8% at end-3Q20, which we view as adequate for the bank's risk profile. Berlin Hyp has stabilised its CET1 ratio in the past few years by retaining almost half of its operating profits to match the RWA inflation triggered by the bank's continued shift to CRE loans from public-sector loans and debt securities investments. We expect that the bank will continue to retain a large share of its profits to mitigate the RWA inflation from the revised Basel III regime, to which its monoline CRE lending model is particularly exposed.

Funding and liquidity are sound and have not been affected by the pandemic. Berlin Hyp sources its purely wholesale funding (unsecured debt and mortgage Pfandbriefe) from a diversified institutional investor base, including members of the savings banks sector. Its membership in SFG's mutual support scheme ensures a 0% regulatory risk weight for its intragroup unsecured debt issuance and, consequently, privileged access to SFG's vast excess liquidity.

SENIOR PREFERRED (SP) DEBT AND DEPOSIT RATINGS

Berlin Hyp's long-term SP debt and deposit ratings are one notch above its Long-Term IDR due to its large buffer of SNP debt equivalent to 47% of RWAs at end-1H20. We believe that this buffer provides the bank's preferred creditors with considerable additional protection compared with senior-non-preferred creditors in a resolution. The bank started to replace maturing legacy SNP debt with cheaper SP debt. However, Fitch believes that Berlin Hyp will retain a comfortable buffer over its MREL.

The short-term SP debt and deposit ratings of 'F1+' are the only options mapping to the respective long-term ratings.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of Berlin Hyp's IDRs and SNP debt ratings would require an upgrade of SFG's ratings.

An upgrade of Berlin Hyp's VR is unlikely in the near term, given the risks posed by the coronavirus shock. In the longer term, rating upside is limited given the bank's concentrated business model. An upgrade would be contingent on a stabilisation of the bank's operating environment and would also require a record of resilient earnings and sound asset quality through the current adverse economic conditions, while maintaining adequate capitalisation and a conservative risk appetite.

Unless Berlin Hyp either includes SP debt in its resolution buffer or the sum of its senior non-preferred and more junior debt buffers falls below 10% of RWA, the bank's long-term SP debt and deposit ratings would be upgraded if its Long-Term IDR was upgraded.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A downgrade of SFG's ratings would trigger a downgrade of Berlin Hyp's IDRs and SNP debt ratings, which are also sensitive to a weakening of the owners' propensity to support. This could result from changes in Berlin Hyp's ownership structure or contractual relationship with the savings banks, in particular Berlin Hyp's membership in SFG's mutual support scheme.

Berlin Hyp's VR has sufficient headroom to withstand various downside scenarios to Fitch's baseline economic forecast. However, it could be downgraded if continued economic disruption from the pandemic places severe and sustained pressure on earnings and asset quality. We could downgrade Berlin Hyp's VR if we expect the four year-average impaired loans ratio to exceed 3% and the four year-average operating profit/RWA to decline below 0.8%.

Berlin Hyp's SP debt and deposit ratings are primarily sensitive to changes in the bank's IDRs. The long-term SP debt and deposit ratings would be downgraded if Berlin Hyp's Long-Term IDR was downgraded or if we expect the bank to include SP debt in its resolution buffer and if the sum of senior non-preferred and more junior debt buffers falls below 10% of RWA.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Berlin Hyp's ratings are driven by potential support from SFG.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Berlin Hyp AG	LT IDR	A+ Rating Outlook Negative	Affirmed	A+ Rating Outlook Negative
	ST IDR	F1+	Affirmed	F1+
	Viability	bbb	Affirmed	bbb
	Support	1	Affirmed	1
• Senior non-preferred	LT	A+	Affirmed	A+
• long-term deposits	LT	AA-	Affirmed	AA-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Berlin Hyp AG	EU Issued

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